STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS AMERICAN WATER COMPANY	**)**	
	)	**Docket No. 16-0093**
Proposed general rate increase in	**)**	
Water and Sewer rates	**)**	

THE PEOPLE OF THE STATE OF ILLINOIS' POSITION STTAEMENT

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THE PEOPLE OF THE STATE OF ILLINOIS' POSITION STATEMENT

Pursuant to the schedule adopted in the above-captioned matter, the People of the State of Illinois (the "People" or the "AG"), through Lisa Madigan, Attorney General of the State of Illinois, submit their Position Statement. The AG's Position Statement follows the agreed-to brief outline submitted to the Administrative Law Judges on August 8, 2016.[1]

I. Introduction

II. Capital Structure and Rate of Return

A. Contested Issues

1. Cost of Common Equity

The AG supports Commission Staff witness Sheena Kight-Garlisch's recommended cost of common equity. Ms. Kight-Garlisch recommended that an 8.12% return on equity ("ROE") if the Commission denies Illinois-American Water Company's ("IAWC" or the "Company") request for Rider VBA and an 8.04% ROE if the Commission approves the rider. (Staff Ex. 13.0 at 1.)

The People strongly oppose IAWC witness Paul R. Moul's recommended 10.75% ROE at 10.75%. (IAWC 10.00 (Rev.) at 2.) The AG agreed with IAWC's comment that the proper

[1] Attached as exhibits to the AG's Position Statement are the AG's recommended revenue requirement schedules for Illinois-American Water Company's Zone 1, Lincoln district, Pekin district and Chicago Metro wastewater.

ROE is the largest issue in this case. (IAWC IB at 1.) However, the AG argued that contrary to IAWC's assertion that Ms. Kight-Garlisch's proposal is untenable (*id.*), it is Mr. Moul's recommendation that is an outlier and must be rejected.

The AG contended that Mr. Moul's recommended is grossly inflated because he relied on several methods that have the singular effect of driving his proposed ROE higher. The AG noted that Ms. Kight-Garlisch testified the Commission has repeatedly and consistently rejected the tactics Mr. Moul used. (ICC Ex. 5.0 at 42, 46, 50, 52.) Despite Ms. Kight-Garlisch pointing this out in her Direct Testimony, Mr. Moul provided no response and offered no explanation as to why the Commission should deviate from its past decisions about the various ROE-inflating methods he used. The AG added that. Kight-Garlish stated that by removing the effects of two of Mr. Moul's adjustments that the Commission has repeatedly rejected reduces his proposed ROE range to 8.89% to 9.00% (ICC Staff Ex. 5.0 at 40), which is far closer to Ms. Kight-Garlisch's proposal and, at the high end, identical to the 9.00% ROE number suggested by Illinois Industrial Water Consumers/Federal Executive Agencies/Citizens Utilities Board ("IIWC/FEA/CUB") witness Michael P. Gorman. (IIWC/FEA/CUB Ex. 1.0 at 4.)

The AG stated that Mr. Moul's first inappropriate adjustment is to add a size-based risk premium to his capital asset pricing model ("CAPM"). (IAWC Ex. 10.00 (Rev.) at 41-42.) The Commission has rejected use of size-based risk premium adjustments in numerous cases. For example, in North Shore Gas Company's ("NS" or "North Shore") and The Peoples Gas Light and Coke Company's ("PGL" or "Peoples Gas") consolidated rate cases in Docket Nos. 11-0280/11-0281 ("NS/PGL 2011 Rate Case"), the Commission rejected Mr. Moul's proposal to add a size-based risk premium to his CAPM result, stating

> … it is simply not reasonable to add an adjustment for the size of a regulated public utility relative to the entire market, because the risk

> characteristics of regulated public utilities are simply unlike those of other firms in the market, which is composed mainly of unregulated firms.
>
> ***
>
> … regulation provides shareholders with a degree of protection that is simply unavailable to non-regulated companies.

North Shore/Peoples Gas, ICC Docket Nos. 11-0280/11-0281 (consol.), Order at 123 (Jan. 10, 2012). ("North Shore/Peoples Gas 2011 Rate Case). According to the AG, the Commission also rejected use of a size-based risk premium adjustment to CAPM results in its IAWC's penultimate rate case, (*Illinois-American*, ICC Docket No. 09-0319 Order at 113 (Apr. 13, 2010)) as well as in its final order in Docket No. 11-0436. (*Aqua Illinois*, ICC Docket No. 11-0436, Order at 38 (Feb. 16, 2012).

Next, the AG discussed Mr. Moul's adjustment to include a leverage adjustment to his discounted cash flow analysis ("DCF"). The AG showed that the Commission has repeatedly declined to adopt leverage adjustments in several previous cases. For example, in NS/PGL's rate cases in Docket Nos. 14-0224/14-0225 (consol.) ("NS/PGL 2014 Rate Case") the Commission rejected Mr. Moul's proposed leverage adjustment. The Commission noted that Mr. Moul's CAPM result was inappropriately inflated because he "appl[ied] a Commission rejected leverage adjustment technique to the beta measurement." (ICC Docket Nos. 14-0224/14-0225 (consol.), Order at 133 (Jan. 21, 2015).) The Commission also rejected Mr. Moul's proposed leverage adjustment in both NS/PGL's rate cases in Docket Nos. 09-0166/09-0167 (consol.) ("NS/PGL 2009 Rate Case") (Order at 127) and Docket Nos. 07-0241/07-0242 (consol.) ("NS/PGL 2007 Rate Case") (Order at 96). Thus, in at least three Commission cases, Mr. Moul has added a leverage adjustment to his DCF analysis. Each time, the Commission has dismissed his proposal.

The AG explained that a third way in which Mr. Moul boosted his ROE was to employ a risk premium model (IAWC Ex. 10.00 (Rev.) at 32-37), yet another tactic the Commission has repeatedly found to be improper. The Commission rejected Mr. Moul's use of a risk premium analysis in: NS/PGL2014 Rate Case (Order at 134) ("this Commission has routinely rejected risk premium analysis as a valid basis for determining return on equity); NS/PGL's rate case in Docket Nos. 12-0511/12-0512 (consol.) (Order at 208) (NS/PGL's "Risk Premium analysis for the Delivery Group is rejected"); NS/PGL's 2011 Rate Case (Order at 139) ("Mr. Moul also calculated ROE values using a Risk Premium analysis. This Commission does not favor the risk premium model which is too subjective to be a reliable tool for determining ROE"); NS/PGL's 2009 Rate Case (Order at 139) ("The Commission will not consider the results of the Utilities Risk Premium model that only the Companies have employed. We have repeatedly rejected this model as a valid basis on which to set return on equity"); and NS/PGL's 2007 Rate Case (Order at 93-93 ("The Commission again rejects the risk premium model"). The AG concluded that on five separate occasions, Mr. Moul recommended that the Commission to use a risk premium model as part of its ROE analysis. In each case, the Commission declined to do so. The AG added that Mr. Moul offered no reason why the Commission should reach a different conclusion here.

The AG also criticized Mr. Moul's use of a comparable earnings analysis to augment his recommended ROE. (IAWC Ex. 10.00 (Rev) at 42-46.) The AG explained that like Mr. Moul's other adjustments and methodologies, the Commission has on several occasions refused to include a comparable earnings analysis as part of its ROE determination. Mr. Moul included a comparable earnings analysis in his testimony in the NS/PGL 2014 Rate Case. The Commission rejected Mr. Moul's proposal, stating

> [NS/PGL also argued that comparable earnings of other companies could be used as a measure of required return. Unfortunately, the

> "comparable" companies used in their analysis don't include any other regulated Companies whose risk profile and earnings are lower than other types of businesses. The Commission finds this a comparison between apples and oranges.

(NS/PGL 2014 Rate Case, Order at 134 (Jan. 21, 2015).)

And the AG pointed out that Ms. Kight-Garlisch identified in her direct testimony several cases in which the Commission rejected a comparable earnings analysis. (Staff Ex. 5.0 at 52.) Among those proceedings are: Docket Nos. 06-0700/06-0071/06-0072 (consol.), Order at 141-142 ("Among other things, the Commission believes that the comparable earnings test is faulty because it incorrectly assumes that earned returns on book common equity are the same as, or representative of, investor-required returns on common equity"); Docket 04-0442, Order at 43-44;and Docket No. 03-0403, Order at 41 ("The Commission has repeatedly found that the comparable earnings approach is an unsound basis for estimating a utility's cost of common equity). As with his other adjustments, Mr. Moul made no effort to explain why the Commission should deviate from its long-held conclusion.

The AG argued that in addition to the various adjustments nad alternative measurement methods Mr. Moul employed, he relied on another tactic the Commission has persistently rejected in past cases. In particular, Mr. Moul dedicated significant portions of his rebuttal testimony and surrebuttal testimony comparing Ms. Ms. Kight-Garlisch's and Mr. Gorman's recommendations to ROEs approved by other public utility commissions around the country. (IAWC Ex. 10.00R at 3-6; IAWC Ex. 10.00SR at 3, 4, 6-7.)

In Docket No. 05-0597, in considering Commonwealth Edison Company's ("ComEd") argument that its ROE should be similar to those authorized for other electric utilities by other commissions, the Commission concluded

> ComEd asserts its cost of equity should reflect the costs of equity recently approved for electric utilities in the United States. The cost of equity appropriate to ComEd, however, is specific to that utility. ComEd may not simply adopt the cost of equity set for other utilities scattered around the country, for which the factors and circumstances are not necessarily similar. Rather, pursuant to Section 9-201 of the Act, ComEd must prove that its proposed cost of equity is just and reasonable.

(*Commonwealth Edison Company*, Docket 05-0597, Order at 153 (June 6, 2006).)

The AG added that in the NS/PGL 2007 Rate Case, Mr. Moul submitted rebuttal testimony comparing the recommended ROEs from Staff and CUB and the City of Chicago to other then-recently-approved ROEs for other energy utilities. (Docket Nos. 07-0241/07-0242 (consol.). NS/PGL Ex. PRM2.0 at 3-6.) Expanding on its finding in Docket 05-0597, the Commission again rejected setting a utility's ROE based on the returns granted other utilities in Illinois or other jurisdictions, saying

> [T]here are important reasons why a commission should not simply match each Utilities ROE to the others previously approved. If our task were merely to maximize [NS/PGL's] ability to attract capital (perhaps to retain investment in Illinois, as the Utilities suggest, Tr. 1047-48 (Moul)), the Commission could just exceed the highest returns already authorized for other utilities. But when the next utility initiated a rate case, we would have to approve an even higher return. Moreover, [NS/PGL] point out that ―regulated firms must compete with non-regulated firms in the capital market.‖ NS-PGL Ex. PRM-1.0 at 41. To assure success in that competition, the Commission would presumably have to equal or exceed returns in the unregulated market as well.

The Commission added

> Less dramatically, we could aim for an average among existing ROEs. However, some percentage of existing ROEs would have been in effect for multiple years and would have been established under different financial market conditions (e.g., with different rates of inflation and costs of debt). The Commission could narrow its comparison to, say, ROEs approved within the last two years, and peg [NS/PGL's] at the average of those. Even then, we would have to ignore any differences among utilities in financial

> strength, capital structure, credit status and utility-specific circumstances, as well as changes in the financial market during the two-year period.
>
> ***
>
> Furthermore, by determining [NS/PGL's] ROEs via comparison to existing ROEs, the Commission would be disregarding its duty to impose only cost-based and reasonable rates on [NS/PGL's] customers. Thus, if we succeeded in providing capital attraction to Illinois utilities, we would also be extracting it from Illinois businesses and homeowners, in the form of excessive rates. And, in the future, other Commissioners could reverse the inequity, by intentionally pegging [NS/PGL's] returns to the lowest comparable existing ROEs.
>
> Plainly, although the notion that [NS/PGL] should enjoy at least an average ROE is superficially seductive, it is an unworkable and improper basis for determining utility returns. It would require us to abandon the course we, along with other commissions, have charted for decades.

NS/PGL 2007 Rate Case, Order at 90-91 (Feb. 5, 2008).

The AG noted that while Mr. Moul testified for the utilities in the NS/PGL 2007 Rate Case and is presumably aware of the Commission's conclusion there, he proposed here that the Commission rely on the "superficially seductive" approach the ICC repudiated in the prior cases. Moreover, Mr. Moul offered no reason why the Commission should diverge from its conclusions in those prior cases.

Finally, the AG argued that in his rebuttal testimony, Mr. Moul testified that the return generated by his various analyses 10.70%. (IAWC Ex. 10.00R at 30.) Mr. Moul then stated that he rounded up the 10.70% "to the nearest one-quarter percentage point, or 10.75%." (*Id.*) There is no other reason or explanation; Mr. Moul gratuitously added five basis points to his recommended return. The AG asserted that the ease with which he increased his alleged professionally-derived result raises serious questions regarding the credibility of Mr. Moul's testimony and his recommendations.

In sum, the AG contended that Mr. Moul's recommended return is seriously inflated. Mr. Moul inappropriately inflated his suggested ROE by adding adjustments, and relying on analyses, the Commission has condemned in case after case. Mr. Moul made no effort to explain away the Commission's past decisions, nor did he make any effort to explain why his presentation in this case is somehow different, thereby meriting different treatment. To top it off, Mr. Moul gratuitously added five basis points to his proposal for no stated reason other than to have a nicely-rounded-off number. The AG argued that the Commission should reject Mr. Moul's recommended ROE.

B. Resolved Issues
1. Capital Structure
2. Cost of Debt
C. Recommended Capital Structure and Rate of Return

III. Rate Base

A. Contested Issues
1. Accumulated Deferred Income Taxes Balance / FIN 48

The AG stated that the Commission has held and the Illinois appellate court has affirmed that "Generally, ADIT quantifies the income taxes that are deferred when the tax law provides for deductions with respect to an item, in a year other than the year in which the item is treated as an expense for financial reporting purposes. For regulated entities, ADIT is treated as a no-cost source of capital that reduces rate base." (ICC Docket 11-0721, *Commonwealth Edison Co.*, Order at 56 (May 29, 2012), citing *Ameren Illinois Co. v. Ill. Commerce Comm'n*, 2012 IL APP (4th) 100962 at 5, 2012 Ill.App.3d LEXIS 175 (4th Dist. 2012).) This is because consumers pay rates that include the full tax bill but the utility does not pay some of the tax bill until a later date (the tax payments are deferred), providing the utility with consumer-supplied, no-cost capital.

In this case, the AG argued that IAWC failed to treat certain ADIT as cost-free capital, in violation of basic ratemaking and accounting principles. Specifically, while the Company took tax deductions related to repairs and realized tax savings from the repairs deduction, the Company is treating the deduction as "uncertain" under FIN 48 and not including the ADIT associated with those "uncertain" tax positions in its rate base deduction. However, until these deferred tax liabilities are actually paid to the relevant taxing authorities, the deferred tax liabilities represent non-investor, no-cost funds that are available to IAWC and should be deducted from rate base. The AG said that the Commission came to this conclusion in IAWC's last rate case, stating "…the FIN 48 amount represents a source of cost-free capital that should be reflected as a rate base deduction." (*Illinois-American Water Co.*,ICC Docket 11-0767, Order at 36).)

The AG explained that the FIN 48 balance represents the amount of deferred tax liabilities related to uncertain tax positions that may ultimately have to be paid to the government. The FIN 48 balance represents the portion of the repairs deduction taken on IAWC's tax returns that the Company believes is uncertain upon audit by the IRS. The AG asserted that in this regard, the FIN 48 balance is no different from any other ADIT balance.

AG witness Effron proposed that the ADIT deducted from plant in service not be reduced by the FIN 48 balance. In rebuttal testimony Mr. Effron stated that the effect is to increase the balance of ADIT by $18,434,822 and to reduce the rate base by the same amount. (AG Ex. 1.0, Sch. B-2; AG Ex. 3.0 at 5; AG Ex. 3.1, Sch. B-2.)

In rebuttal testimony, Company witness Wilde agreed that IAWC would eliminate the adjusted FIN 48 deferred tax asset balance from rate base. (IAWC Ex. 13.0R at. 9-10.) However, Mr. Wilde added that Illinois-American would not be claiming as much in tax repair

deductions as previously claimed. He proposed to update the Commission about its claimed FIN48 and offsetting deferred tax asset in the AIWC's surrebuttal testimony.

In surrebuttal testimony, the Company argued that the amount of the FIN48 adjustment proposed by AG witness Effron in direct and rebuttal testimony (AG Exs. 1.1 and 3.1, Sch B-2) was incorrect and provided a much smaller amount of $3,432,525. The Company claimed that the amount of the FIN 48 adjustment should be further reduced to $2,485,188 to reflect the adjustment to prior repair deductions that IAWC states that it expects to take in filing its 2015 tax return. (IAWC Ex. 13.00SR (Rev.) at. 2-4.) The People accepted the Company's corrected amount of the FIN 48 adjustment to rate base of $3,432,525 rather than the original adjustment of $18,434,822 proposed by AG witness Effron in his direct testimony.

The AG argued that the Company, however, did not reduce rate base by the "corrected" $2,485,188 amount in the schedules calculating the Company's proposed surrebuttal revenue requirement as Company witness Wilde said IAWC would do. The Company seemed to have removed the FIN48 repairs deduction for the 2015-2017 accruals in IAWC Schedules B-9 and 9.1 IAWC Ex. 4.08SR (Rev.) at line 5), but did not removed the $2,485,188 from rate base, although Mr. Wilde testified that such an adjustment would be made:

- "[t]he adjustment to prior repairs deductions has been computed, and the change results in IAWC realizing $909,707 of its FIN48 obligation, reducing the amount of the ADIT impact on rate base from $3,432,525 to $2,485,188" and
- "[t]he amount to be removed is $2,485,188." (IAWC Ex. 13.00SR (Rev.) at. 2-3.)

In surrebuttal testimony, as support that the rate base deduction should be $2,485,188 rather than the $3,432,525 Company witness Wilde offered to provide a confidential disclosure of Form 3115 or a copy of the IAWC federal pro forma tax return as a compliance filing in this docket. The Company's tax returns are filed 8 ½ months after year end. (IAWC Ex. 13.00SR (Rev.) at. 3-4.)

Thus, the AG pointed out the filed Form 3115 should be available during the briefing stage of this case and should be provided as evidence to support the lower rate base deduction. The AG added that as for the offer of a "federal pro forma tax return," IAWC's offer is not definitive because it is not the "actual" tax return that will be filed and should not be accepted by the Commission as proof that the Company changed its tax considerations of its repair deductions.

The AG explained that in IAWC's last rate case, Docket No. 11-0767, the Commission rejected the AG's recommendation to not consider bonus depreciation in the calculation of accumulated deferred income taxes based upon the utility's testimony that American Water Works Company (IAWC's service company) had decided to not utilize 2011 bonus depreciation. (ICC Docket No. 11-0767, Order at 70 (Sep. 19, 2012). However, in information submitted in this case, the AG argued that it turns out that bonus depreciation was utilized in 2011 as shown in IAWC WPC – 5a. (AG Group Exhibit Part 2 at 10.) That document shows that the Company applied bonus depreciation in 2008-2014 to its taxable income contrary to the Company's assurances in Docket No. 11-0767.

The AG asserted that the Commission should not be misled again. Without AIWC's filed Form 3115 evidence that the Company actually changed its tax method of accounting for repairs in filing its 2015 Corporate Income Tax return, the Commission should reject the Company's proposed change in its tax considerations of repair deductions and reduce rate base by the AG's recommended amount of $3,432,525.

2. Debt Return on Pension Asset

AG witness Effron recommended that the Commission reduce rate base by the accrued "other post-employment benefits" or OPEB liability in the amount of $1,898,284. (AG Ex. 3.0 at 7.) Mr. Effron explained that Statement of Financial Accounting Standards 106 requires the

Company to accrue for the payment of future post-retirement benefits other than pensions and that when the accruals are greater than the actual cash disbursements, accrued liabilities will be reflected on the Companies balance sheets. (*Id.*) The AG noted that the Commission has consistently applied this rule in IAWC's rate cases. (ICC Docket No. 11-0767, Order at App A, page 4, line 18 (Sep. 19, 2012).)

IAWC accepted Mr. Effron's adjustment, but IAWC witness Kerckhove argued that if the Company's rate base is reduced by the accrued OPEB liability, then the Company should be allowed to include in the cost of service a debt return on pension assets. In support of its previously-rejected position, the Company pointed to formula rates provided to participating utilities under the Energy Infrastructure Modernization Act ("EIMA"), (220 ILCS 5/16-108.5(c)(4)(D)) and ComEd's rate case in Docket No. 05-0597. (IAWC IB at 28.) The AG asserted that neither instance provides justification for the Commission to abandon its consistent regulatory practice for the regulatory treatment of pension assets and OPEB Liabilities.

As to EIMA, the AG argued that that statute does not apply to IAWC. IAWC is not a participating electric utility under EIMA and has not satisfied the various provisions required of the participating utilities under EIMA. IAWC is not entitled to, and should not be provided, the various regulatory benefits that result from being a participating utility under that statute. In short, the AG concludes, the formula rate statute is not germane.

The also AG explained that the facts of Docket No. 05-0597 do not apply to the instant case. In that case, the Commission allowed a debt return on the contribution that Exelon Corporation ("Exelon") made to ComEd to fund the latter's pension trust fund. However, the Commission did not allow a debt return on a "pension asset," which is what IAWC seeks here. The AG stated that the Commission provided a debt return only on the pension contribution

made by Exelon to fully-fund the pension obligation. Further, the Commission based its conclusions on the specific facts of the case and cautioned that this conclusion should not be used as precedent for future proceedings. The Order stated:

> Accordingly, the Commission approves cost recovery of the Pension Asset under Alternative 3 that ComEd proposed on rehearing. However, in doing so, the Commission does not sanction the prefunding of a utility pension plan as a mechanism to increase base rates. Clearly, Exelon chose to prefund ComEd's pension plan with an equity contribution expending a rate of return. ***This Commission bases its conclusion on this issue on the specific details of this proceeding, not to be construed as precedent for future proceedings concerning pension plan funding***.

(*Commonwealth Edison Co.*, Docket No. 05-0597, Order on Reh'g at 28 (Dec. 20, 2006) (emphasis added).)

The AG stated that contrary to the facts in Docket No. 05-0597, IAWC has provided no evidence here that its pension asset was funded with anything other than ratepayer funds. Thus, the Commission's fact-specific decision in Docket No. 05-0597 provides no support for IAWC's request in this case.

The AG argues that the Company has presented no compelling reason for the Commission to change its prior regulatory treatment of the accrued OPEB Liability and pension asset. In the Company's prior rate case, Docket No. 11-0767, the Commission denied the Company's request for a pension asset to be included in rate base while also accepting the Company's rate base deduction for the OPEB Liability. As it did in that case, the Commission should reject IAWC's position and reduce rate base by $1,898,284.

3. Cash Working Capital for Deferred Income Tax

In rebuttal testimony, IIWC/FEA/CUB witness Gorman recommended that no cash working capital ("CWC") requirement be provided for deferred income taxes. He explained that this treatment of deferred income taxes for CWC is consistent with how both he and IAWC witness Walker had treated depreciation expense, which is also a non-cash item, and that the treatment was also consistent with how the Commission treats deferred income taxes in the determination of CWC requirements for formula rates. (IIWC-FEA-CUB Ex. 2.0 at 38.)

The Company argues that its treatment of deferred taxes in the CWC is consistent with past Commission findings and with the Staff's recommended approach in this proceeding. The Company maintains that Mr. Gorman's proposal excludes the revenues associated with deferred taxes from the CWC calculation and therefore ignores the lag between IAWC's recorded deferred tax amount and its collection of that amount from customers. (IAWC Ex. 12.00SR at 4.)

The AG argued that the Company mischaracterized the purpose of CWC. CWC is not measured by the receipt of cash from ratepayers in relationship to the recording of expenses. Expenses such as deferred income taxes are recorded but do not reflect payment. CWC is necessary to provide the funds required to pay the day-to-day expenses incurred by the utility to provide service to customers. Deferred income taxes are not currently paid and, therefore, do not require any funds to pay the yet-to-be paid taxes. Accordingly, there is no associated CWC requirement. (IIWC/FEA/CUB Ex. 2.0 at 36-37.)

IAWC witness Walker argued that Mr. Gorman's reliance on the calculation of cash working capital in electric formula rate update filings by Ameren-Illinois and ComEd as not germane because those cases "…involve electric utilities participating in the performance-based formula rate scheme established by the Energy Infrastructure Modernization Act." (IAWC Ex. 12.00SR at 5.) However, the AG pointed out that IIWC-FEA-CUB's method for the

consideration of deferred income taxes in the calculation of cash working capital has been applied in rate cases other than the electric formula rate update proceedings. The method was also adopted by the Commission in the last rate case proceedings of Peoples Gas and North Shore. (*North Shore Gas Co./The Peoples Gas Light and Coke Co*., Docket Nos. 14-0224/14-0225 (cons.), 2nd Amendatory Order, App A at 9-10 and App B at 9-10 (Feb. 11, 2015).

Consistent with its decision in the recent Peoples Gas and North Shore rate cases, the AG argued that the Commission adopt the IIWC-FEA-CUB adjustment to subtract deferred income taxes from revenues in the cash working capital calculation. Deferred income taxes, like depreciation expense, are a non-current item, and, therefore, should have the same treatment.

B. Resolved Issues

1. Accrued Liability for OPEB

The Company reduced its rate base for the Accrued Liability for OPEB in its surrebuttal testimony as recommended by AG witness Effron's direct and rebuttal testimonies. (IAWC Ex. 4.04SR, col (g).)

2. Capitalized Prior Performance Plan Costs

In direct testimony, AG witness Effron removed the 2012-2016 capitalized cost of performance plans that were not included in the revenue requirement in the Company's last rate case, Docket No. 11-0767. (AG Ex. 1.0 at 10.) Company witness Kerckhove indicated that the Company accepted the adjustment. (IAWC Ex. 4.0R at 16.) In rebuttal testimony, AG witness Effron and Staff witness Kahle removed the 2012-2016 capitalized costs of the performance plans for the Lincoln and Pekin Districts because the adjustment for Pekin and Lincoln had been inadvertently overlooked in the preparation of the Company's rebuttal revenue requirement schedules. (AG Ex. 1.0 at 6 and Staff Ex.

11R at 12.) The Company incorporated the adjustments for Pekin and Lincoln into the Company's revenue requirement schedules. IAWC Ex. 4.04SR (Rev.), col (f) for Pekin and Lincoln.

3. Cash Working Capital

a. Tank Painting Amortization

b. Rate Case Expense Amortization

4. Accumulated Deferred Income Taxes

a. Deferred Tax Assets for UPAA and Deferred Rate Proceedings

In direct testimony, AG witness Effron and Staff witness Hathhorn corrected the ADIT balance to remove the deferred taxes for net utility plant acquisition adjustments and deferred rate proceedings as agreed to in the Company's response to Data Request AG 3.027. (AG Ex. 1.0 at 11, AG Ex. 1.1, Sch. B-4; Staff Ex. 2.0 at 4.) In rebuttal testimony, Company witness Kerckhove incorporated the adjustment into its rebuttal revenue requirement schedules. (IAWC Ex. 4.04R, col (d).)

b. Restated for Change in State Income Tax Rate

In response to the Company's adoption of a 7.75% effective state income tax (or "SIT") rate in its rebuttal testimony, AG witness Effron and Staff witness Hathhorn proposed an adjustment to restate the ADIT balance to reflect the 7.75% SIT rate rather than the 5.25% SIT rate embedded in the ADIT balance proposed in the Company's rebuttal testimony. (AG Ex. 3.0 at 6-7; Staff Ex. 10.0 at 4.) IAWC witness Kerckhove revised the calculation of the ADIT balance using the 7.75% SIT rate and incorporated the adjustment into the Company's surrebuttal revenue requirement schedules. (IAWC Ex. 4.0SR at 10 and IAWC Ex. 4.04SR, col (h).)

5. Deferred Charges related to Cairo Filter Project

In direct testimony, AG witness Effron and Staff witness Hathhorn corrected the test year balance of deferred charges and the related amortization for two filter projects in Cairo that should not

have been included as deferred maintenance as indicated in the Company's response to Staff Data Request DLH 3.001. (AG Ex. 1.0 at 10 and AG Ex. 1.1, Sch. B-4. Staff Ex. 2.0 at 4.) In rebuttal testimony, Company witness Kerckhove incorporated the adjustment into its rebuttal revenue requirement schedules. (IAWC Ex. 4.04R, col (c).)

6. Accumulated Depreciation Correction

C. Original Cost Determination

D. Recommended Rate Base

IV. Operating Expenses and Revenues

A. Contested Issues

1. Payroll Expense

The AG stated that the Company's 2017 test year employee forecast is based on an average of 482 positions (479 full-time permanent positions and 13 additional temporary full-time summer positions from June through August 2017) reduced by a vacancy rate of 2.5% to account for approximately 12 anticipated position vacancies or 470 full-time employees (482 less 12). (IAWC Ex. 2.00R (2nd Rev.) at 2.). AG witness Effron, IIWC/FEA/CUB witness Gorman, and Staff witness Daniel G. Kahle proposed adjustments to reduce payroll expense for a vacancy rate that exceeded 2.5% based upon the Company's actual experience since 2014. The AG summarized each witness's vacancy rate and different derivative adjustments in the table below.

	AG Ex. 3.1, Sch. C-2	**IIWC/FEA/CUB Ex 2.0 at 26-27**	**Staff Ex 11, Sch. 11.08**
Gross Vacancy Rate Applied	5.77%	7.92%	5.40%
Less Company Vacancy Rate	2.50%	2.50%	2.50%
Additional Vacancy Rate Applied	3.27%	5.42%	2.90%
Basis for Vacancy Rate	Avg. Jan 2014-May 2016	Avg. June 2015-May 2016	Weighted Avg. Jan '14-Feb '16
FICA Expense	X	X	X
401K	X	X	
Group Insurance	X	X	
Defined Compensation	X		

Capitalized 2017 Payroll	X		X
Capitalized 2016 Payroll	X		

AG Ex. 1.0 at 12-14, AG Ex. 3.0 at. 7-10; IIWC/FEA/CUB Ex.t 1.0 at 9-11, IIWC/FEA/CUB Ex. 2.0 at.23-28; Staff Ex. 3.0 at 14-15, Staff Exhibit 11.0 (Rev.) at 10-12.

The AG noted that the actual vacancy percentage since 2014 has been consistently higher than the vacancy percentage assumed by the Company in forecasting the test year headcount. For May 2016, the most recent month in which data was available, the actual vacancy rate was 10.34%, for the months between July 2015 and April 2016 the highest and lowest monthly vacancy rates ranged from 7.10% to 9.41%, and the average actual monthly vacancy rate for 2014 was 4.79%. (AG Ex. 3.1, Sch. C-2.)

Company witness Smyth asserted in rebuttal that if positions are unfilled, current IAWC employees and/or temporary employees must do the required work, increasing IAWC's overtime and temporary labor expenses. He also claimed that IAWC's increased overtime and temporary labor expenses since 2013 are due to IAWC's unfilled planned full-time positions. (IAWC Ex. 2.00R at 2-10.) The AG argued that Mr. Smyth's contention regarding temporary labor expense is contradicted by the fact that its actual temporary labor expense from January through May, 2016 of $23,000 is below the budgeted year-to-date amount of $35,000. (AG Group Exhibit Part 3 at 8-9, IAWC Response to Data Request AG 10.005.)

Moreover, the AG asserted that the Company's argument that its overtime expense would increase with a higher vacancy rate is unfounded. There can be many reasons for increased overtime and temporary labor expenses. Overtime can be the result of many factors and only a percentage of IAWC's overtime can be attributable to its actual vacancy rate. (AG Group Exhibit Part 3 at 38-39, Staff Responses to Data Requests AG 1.0 and 2.0.) The AG cited page

45 of the Form 10-K for December 31, 2014 for American Water Works states that there was "…an increase in salaries and wages expense in 2014 as a result of annual wage increases and *increased overtime expense attributable to an increased number of main breaks as a result of the harsh winter weather conditions* and increases in severance expense as a result of the restructuring of certain functions…." (AG Ex. 3.0 at 9 (emphasis added).) The AG claimed that the Company has not provided any evidence of the percentage of the increased overtime costs that is attributable to the increased vacancy rate. Thus, the Commission should not consider the incremental overtime costs in its determination of an adjustment to recognize the Company's increasing vacancy rate.

The AG noted that IAWC also argues that any payroll vacancy adjustment should be offset by the average by which IAWC's overtime expenses have exceeded budgeted expenses from 2013 to date. IAWC Initial Brief at 41. IAWC claims that Staff witness Kahle agrees with the Company's position. However, Staff witness Kahle stated that only a percentage of IAWC's overtime can be attributable to the actual vacancy rate. (AG Group Exhibit Part 3 at 38-39, Staff Responses to Data Requests AG 1.0 and 2.0.) Thus, Mr. Kahle's position does not provide the support the Company claims.

The AG added that IAWC has not provided any data that would permit the Commission to calculate a percentage of the increased overtime costs that might be attributable to the increased vacancy rate. Clearly, the percentage of the increased overtime costs attributable to the increasing vacancy rate is not 100%. Unless the Commission chooses to arbitrarily select a percentage of overtime that might be attributable to the Company's increasing vacancy rate, the Commission should not consider the incremental overtime costs in its determination of an

adjustment. Applying the vacancy rate proposed by AG witness Effron rather than the higher vacancy rate proposed by IIWC-FEA-CUB witness Gorman would provide a fair compromise.

The AG argued that in addition to adopting the adjustment to recognize the Company's increasing vacancy rate it should also the derivative adjustments proposed by AG witness Effron:

(1) FICA payroll tax also proposed by Staff witness Kahle and IIWC/FEA/CUB witness Gorman;

(2) 401K expense and group insurance adjustments also proposed by Mr. Gorman;

(3) Defined contribution plan that provides all employees hired after 1/1/2006 a 5.25% base pay defined contribution plan (AG Group Exhibit Part 3 at 12, IAWC Response to Data Request AG 12.003.);

(4) Capitalized 2017 payroll as proposed by Staff witness Kahle; and

(5) Capitalized 2016 payroll as the capitalized 2016 payroll represents a forecast and is not the actual capitalized 2016 payroll.

The AG said that in response to IAWC's claim that Mr. Effron had improperly applied certain benefits to the vacancy positions, including the employee benefits of pension, OPEB, retiree medical, and ESPP, Mr. Effron removed those items from his calculation of his proposed adjustment in his rebuttal testimony. As a result, the AG's corrected derivative effects for its proposed adjustment for the increasing vacancy rate.

In conclusion, the AG urged the that the Commission should adopt the corrected adjustment proposed by AG witness Effron in his rebuttal testimony that applied a vacancy rate of 5.77% reduced by the Company's 2.5% vacancy rate to 2017 payroll expense and benefits that include the 401k, Defined Compensation, and Group Insurance, 2016 and 2017 capitalized payroll, including that include 401k, Defined Compensation, and Group Insurance.

2. Annual Performance Plan Expense (Resolved between IAWC and Staff)

Company witness Watkins accepted Staff witness Kahle's adjustment to disallow 50% of the costs attributable to the Annual Performance Plan ("APP") subject to a correction regarding payroll taxes in surrebuttal testimony. (IAWC Ex. 7.00SR (Rev.) at 10-11.) While the AG does not object to IAWC's concession, Mr. Effron recommended that 100% of the cost of IAWC's performance plans be disallowed because no payment can be made to any participant in the APP, or short-term variable compensation program, unless the corporate financial performance of *American Water,* IAWC's corporate parent, achieves at least 90% of the targeted earnings per share. The AG argued that the Company witness Robert V. Mustich admitted as much, stating:

> American Water's program requires the achievement of at least 90% of target [earnings per share] performance to ensure the financial viability of the plan before any short-term variable compensation payment can be made to any participant.

(IAWC Exhibit 9.00 at 10.) Thus, according to the AG, the payout of APP to its participants is dependent upon the financial success of each of the affiliates of IAWC, not just IAWC. Since payment of the APP is dependent on the achievement of American Water to achieve a threshold financial performance level, the APP primarily benefits shareholders, not ratepayers. (AG Ex. 1.0 at 14-15.)

The AG argued that the Commission has consistently and routinely found that it is inappropriate to include in rates the costs associated with incentive compensation programs that condition payment on corporate financial goals. (*Id*.) For example, in the Company's prior rate case, Docket No. 11-0767, IAWC did not oppose a Staff adjustment to remove a portion of the cost of the performance plan that the Company inadvertently had not removed. (ICC Docket 11-0767, Order at 48. (Sep. 19, 2012).) And in a prior IAWC rate case, the Commission disallowed all costs of the performance plans, finding that:

> The Commission has consistently disallowed recovery of payouts that are tied to overall company financial goals. ***As is apparent from previous rate orders, the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations which provide net benefits to ratepayers***. In this case, no such showing has been made by IAWC.
> … In no way does the Commission mean to suggest that IAWC should not be using an incentive compensation plan. On the contrary, if use of the AIP helps IAWC meet its financial goals as well as minimum statutory and regulatory requirements, the Commission has no objection to its continued use. The Commission, however, does object to the notion that ratepayers should have to help encourage IAWC's employees to meet goals benefitting shareholders and meet minimum service obligations.

Docket No. 07-0507, Order at 25-27 (July 30, 2008) (emphasis added).

The AG argued that IAWC's reliance on the Commission's Order in Docket No. 14-0312 as support for its position that it should be allowed to recover incentive compensation costs for a plan that requires the attainment of certain financial goals for employees to receive payment is misplaced. The AG pointed out that the Commission's Order in that case shows that the Commission does not consider conditioning incentive compensation costs on the attainment of financial goals as prudent or reasonable.

In its Order in Docket No. 14-0312, the Commission directed ComEd to develop an incentive compensation plan that was not based on the earnings per share ("EPS") or any other financial performance metric of ComEd's corporate parent, Exelon. The Commission added that the Commission expected that this revised plan would be reflected in ComEd's next formula rate update or the Company would run the risk of continued disallowance of such expenses. Specifically, the Order stated:

> …the Commission is concerned about the EPS limiter's potentially detrimental effect on ratepayers in a scenario where Exelon's EPS

> is too low and ComEd employees receive no AIP[2] compensation regardless of their performance on operational metrics. …the potential exists for such a situation and the Commission seeks to avoid any scenario in which an incentive program provides a disincentive for employees to produce the maximum available benefits for ratepayers.
>
> …
>
> …With this in mind, the purpose of the EPS limiter is unclear. It does not benefit ratepayers, as suggested by ComEd, because it could potentially provide a disincentive to employees to meet the operational metrics when Exelon's earning are too low. Also, the design of the AIP could result in above market salaries if the performance on the operational metrics and the earnings per share are high enough. In a footnote to its Reply Brief, ComEd states that the EPS limiter is in place to provide consistency across the Exelon family. ComEd Reply Brief at 24. The Commission notes that ComEd strenuously argued that the EPS limiter is not prohibited by EIMA, ***but failed to convince the Commission that its annual incentive plan with its EPS limiter is reasonable and prudent. The Commission directs ComEd to develop an incentive compensation plan that is consistent with EIMA and does not include an SPF[3] based on Exelon's EPS or any other financial performance metrics***. In order to demonstrate that the entirety of the Company's incentive compensation expenses are reasonable and prudent, ***the Commission expects that this revised plan will be reflected in ComEd's next formula rat update or the Company will run the risk of continued disallowance of such expenses.***

Commonwealth Edison Co., Docket 14-0312 Order at 51 (Dec. 10, 2014) (emphasis added).

The AG further stated that Docket No. 14-0312 is unlike this case in fundamental ways. Docket No. 14-0312 was a ComEd formula rate update case. ComEd's formula rates under Section 16-108.5 of the Public Utilities Act differ from IAWC's rates determined under Section 9-201; formula rates are only in effect for one year while IAWC's rates will be in effect for an unknown period of time. Moreover, there has been no analysis to determine the differences

[2] AIP stood for ComEd's Annual Incentive Plan.

[3] SPF stood for the Shareholder Protection Feature, *i.e.* the EPS-related limiter, of ComEd's 2013 AIP.

between ComEd's incentive pay plan considered by the Commission in Docket No. 14-0312 and IAWC's plan under consideration in the instant proceeding.

Company witnesses Smyth (IAWC Ex. 2.00R (2nd Rev.) at 10-14), Watkins (IAWC Ex. 7.00R at. 21-35), and Mustich (IAWC Ex. 9.0R at 1-7) argued that the APP Plan has reduced expenses and created greater efficiencies in operations which have benefited utility customers. The Company stated that the reduction of operating expenses by 3% since the Company's last rate case and the five-year delay between rate cases is evidence that the APP Plan has benefited utility customers.

But, the AG pointed out that the Company has not shown any link between the incentive compensation plan tied to financial goals and any identified reduction in operation and maintenance expenses or delay in the filing of rate cases or, further, that these efficiencies would not have been achieved in the absence of incentive compensation based on financial goals. Mr. Effron argued that many factors, such as weather, water usage, and technology, can affect changes in expenses or the time between rate cases. (AG Ex. 3.0 at 10-11). In addition, rate changes, such as the use of a QIP rider, which increased costs to consumers and revenue to the Company of $8,762,665 during 2015 (*See* ICC Docket No. 16-0181, IAWC Petition to Initiate Reconciliation Proceeding) may affect the frequency of rate cases. Other than general assertions, the AG asserted that the Company has provided no evidence that the incentive compensation program has affected the results of operations or its revenue increase request.

Moreover, other IAWC witnesses identified reasons for reduced expenses that have nothing to do with existence of the APP:

- Company witness Roach stated "Over the long term, ***reduced usage per residential customer has helped lower operating costs***, and has helped avoid some capacity-related

needs. These savings and avoided costs have benefitted customers through the ratemaking process." (IAWC Ex. 8.00 at 14 (emphasis added).)

- Mr. Roach added "As a result of … ongoing reductions in water usage, the water utility industry has avoided the need to build supply, treatment, and transmission facilities to meet those now avoided additional usage demands." (*Id.* at 14-15.)
- Company witness Hauk stated that "And our water efficiency efforts are demonstrated *by* ***investments in new metering and innovative data collection technologies,*** and by improved business processes that help us work smarter and more efficiently and, by extension, contribute to our cost control efforts. Our ability to reduce O&M from the level approved in our 2011 rate case proves the effectiveness of these efforts, and the consequent cost benefit to our customers.**"** (IAWC Ex. 1.0 at 12 (emphasis added).)

The AG concluded that the Commission should adopt the AG's adjustment to remove the remaining 50% of the APP because the Company has not established that the APP has been directly responsible for any reduction in operation and maintenance expenses or a delay in the filing of the current rate case or that these cost reductions would not have been achieved in the absence of incentive compensation based on financial goals.

3. Purchased Power Expense

The AG stated that IAWC included electricity capacity charges in its purchased power expense. In 2015-16 the capacity charges in the Midcontinent Independent System Operator ("MISO") area that serves some IAWC facilities jumped from $16.00 to $150 for June 1, 2015 through May 30, 2016. In 2016-2017 the capacity charge dropped to $72.00. (AG Ex. 1.0 at 20-21.) Despite the more than 50% decrease in capacity costs for the 2016-2017 period, IAWC increased the MISO capacity charge in its test year. AG witness. Effron removed the part of the

Company's pro forma adjustment to fuel, power, and chemical expense that increased production costs from the high $150 capacity charge in 2015/2016. Mr. Effron testified that the Company's pro forma adjustment to increase the purchased power costs over the 2017 projected level was not supported and using the 2015/16 capacity charge of $150.00 would likely overstate IAWC's purchased power costs. (AG Ex. 1.0 at 20; AG Ex. 3.0 at 13.)

The AG noted that Company witness Smyth testified that he "…agrees that, due to the capacity price flow-through, if viewed in isolation, IAWC will temporarily benefit from the reduction in capacity prices in the [MISO] territory from June 1, 2016 through May 30, 2017." However, he argued that there was no assurance that prices will not swing up again in the second half of the test year when MISO holds it capacity auction for the 2017/2018 planning year. (IAWC Ex. 2.0 at 14-17.)

AG witness Effron agreed that while there is no assurance that prices *will not* swing up in the second half of 2017, there is also no assurance that the prices *will* go down in the second half of 2017. (AG Ex. 3.0 at 13.) Moreover, the AG pointed out that Mr. Effron's adjustment did not change the Company's original forecast for 2017 power costs that considered several factors including the $150 per megawatt-day passed through MISO capacity price that was in effect through May 30, 2016.

The AG adjustment is conservative in that it only removes the Company's pro forma adjustment *to increase* the costs greater than the projected 2017 power costs that were based on the $150 per megawatt-day pass through MISO capacity price, despite the fact that, as noted above, MISO capacity prices have decreased by more than 50% to $72 per megawatt/day for 2016-2017. The AG urged that the Commission adopt the AG adjustment to reduce the test year power costs $219,035.

4. Test Year Sales Level

5. Uncollectible Rate in Lincoln

The AG stated that IAWC applied a uniform Gross Revenue Conversion Factor ("GRCF") to all of its divisions to avoid the complexity of maintaining separate uncollectible rates for each zone. However, the AG argued that it is hard to accept the Company's complaint when the Company has a history of maintaining separate uncollectible rates for its various divisions. For the projected 2017 test year, the calculated uncollectible rate for Lincoln was 0.92% while the uncollectible rate for the other divisions were 0.95%. For projected 2016, the calculated uncollectible ratio for Chicago Metro-Wastewaster was 0.880% while the uncollectible ratios for the other divisions were 0.900%. And for 2014 and 2015, the actual uncollectible ratios differ for all divisions.

Year	Zone 1	Chicago Wastewater	Pekin	Lincoln
Test Year 2017	0.950%	0.950%	0.950%	0.920%
Projected 2016	0.900%	0.880%	0.900%	0.900%
Actual 2015	1.060%	1.810%	1.440%	1.180%
Actual 2014	1.710%	3.120%	2.45%	2.010%

AG Group Exhibit Part 1 at 61, IAWC Schedule C-16 Line 23.

The AG asserted that a separate GRCF for each district is appropriate. Having four GRCFs rather than one GRCF adds little complexity for a rate case when there are already separate revenue requirements for each district. Moreover, doing so would be consistent with the Commission's finding in a prior IAWC rate case, Docket No. 09-0319, where the Commission concluded that the uncollectible factor used in the GRCF should be different for each district. The Order stated:

> The Commission also finds convincing AG/JM's assertion that its proposal to calculate a district-specific uncollectibles factor

> produces a more accurate estimate of the district specific revenue requirement.

IAWC, ICC Docket 09-0319, Order at 60 (Apr. 13, 2010).

The AG concluded that the Commission should approve the use of a separate GRCF for the Lincoln division so that consumers in that division can benefit from the lower uncollectible rate in that area.

6. Demand Study Costs

In his direct testimony, AG witness Rubin testified that he agreed with IAWC's request to discontinue collecting demand data, stating that the demand data the utility has gathered for this case should be useable for many years going forward. (AG Ex. 2.0 at 16.) Accordingly, Mr. Rubin recommended that Company's revenue requirement be reduced by $69,460. (*Id*. at 16-17; AG Ex. 2.7.)

In his rebuttal testimony, Mr. Rubin explained that in a response to an AG data request attached to his direct testimony, IAWC stated that it would save by no longer collecting demand data. The $69,460 number is the basis for Mr. Rubin's proposed reduction to the revenue requirement. However, in its rebuttal testimony, the Company did an about-face and claimed that there are no savings associated with discontinuing collecting demand data because the expenses are deferred, and not considered a current cost of service. IAWC should be held to its first position, that is, that $69,460 should be removed from its revenue requirement request. In its direct case, Company witness Jeffrey T. Kaiser testified that "IAWC would accept an adjustment to test year expenses to remove the cost related to the collection and compilation of the direct measurement data if the Commission approves discontinuance of the data collection." (IAWC Ex. 3.00DT at 31-32.) And, in responding to the AG's data request, the Company

quantified the amount associated with collecting the demand data that should be removed from the revenue requirement.

The AG argued that the Company's change in position in rebuttal testimony responded to no party. No party opposed AIWC's proposal to discontinue collecting demand data and to remove the associated costs from its proposed revenue requirement. Therefore, the AG requested that $69,460 should be removed from the revenue requirement approved in this case.

B. Resolved Issues

1. State Income Tax Rate

In his direct testimony, AG witness Effron proposed an Illinois SIT rate of 7.75% multiplied by the average effective apportionment factor of 26.899% provided in the Company's response to Staff Data Request DLH 4.004 for an effective SIT apportioned rate of 2.0846%. (AG Ex. 1.00 at 5.) The Company used an average effective apportioned SIT rate of 3.399%. Staff proposed an apportioned SIT rate of 1.8829%. (ICC Staff Ex. 1.0, Sch. 1.07.)

In rebuttal testimony, Company witness Wilde agreed with the use of a state income tax rate of 7.75%, but testified that the Company had been incorrectly using a five-year average estimate of American Water's apportionment factor when it should have been using the 100% apportionment factor reflecting IAWC's activities in the state of Illinois. (IAWC Ex. 13.0R at 3.) In response, AG witness Effron accepted the 100% apportionment factor and applied a 7.75% SIT rate with a 100% apportionment factor but also proposed a new adjustment to restate the ADIT balance to reflect the 7.75% state income tax rate. (AG Ex. 3.0 at 6-7; AG Ex. 3.1, AG Schedule B-5.) Staff also accepted the 7.75% SIT rate in its rebuttal testimony and proposed a new adjustment to restate the ADIT balance at the 7.75% SIT rate. (ICC Staff Ex. 10.0 at 4.)

2. Income Tax Expense

In his direct testimony, AG witness Effron proposed adjustments to current and deferred state and federal income tax expense. In addition, AG witness Effron applied a state income tax rate based upon the statutory rate of 7.75% reduced by an apportionment factor rather than the Company's proposed rate of 9.93% reduced by an apportionment factor in calculating the current and deferred state income tax expenses. The AG methodology to determine taxable income began with the Company's pre-tax operating income as shown on IAWC Schedule C-2 and subtracted interest expense and added or subtracted the other tax reconciling items as shown on IAWC Schedule C-5. (AG Ex. 1.0 at 22-25.)

In rebuttal testimony, IAWC witness Kerckhove agreed with the method used by AG witness Effron for determining taxable income but claimed that the federal taxable income did not properly deduct state income tax expense. (IAWC Ex. 4.00R at 14.)

In rebuttal testimony, AG witness Effron accepted the Company's calculation of the state and federal deferred income tax expense but did not agree with the Company's calculation of the revised state and federal current income tax expense at present rates. Mr. Effron presented an updated calculation of state and federal current income tax expense on AG Schedule C-7 using the methodology presented in direct testimony. (AG Ex. 3.0 at 14-16.)

In its surrebuttal testimony, IAWC agreed that its adjustment to income tax expense used in the Company's rebuttal filing was in error and revised its adjustment to current income tax expenses to match the calculation of income tax expense on the Company Pro Forma Present. (IAWC Ex. 4.00SR at 11.)

3. Advertising Expense

4. Lobbying Expense

AG witness Effron and Staff witness Kahle removed employee lobbying expense. (AG Ex. 1.0 at 26; ICC Staff Ex. 3.0 at 9.) IAWC witness Kerckove accepted the adjustment in rebuttal testimony. (IAWC Ex. 4.00R at 4.)

5. Outside Professional Services Expense

Both AG witness Effron and Staff witness Kahle removed SFIO outside professional services expense. (AG Ex. 1.0 at 25; ICC Staff Ex. 3.0 at 10.) IAWC witness Kerckove accepted the adjustment in rebuttal testimony. (IAWC Ex. 4.00R at 4.)

6. Invested Capital Tax

In his rebuttal testimony, AG witness Effron adjusted invested capital tax expense based on Staff's proposed average combined long-term debt and common equity from the capital structure. (AG Ex. 3.0 at 16-17; AG Ex. 3.1, Schedule C-9.) In the Company's surrebuttal testimony, IAWC witness Kerckhove accepted the adjustment to invested capital tax as the Company accepted the equity adjustment proposed by Staff witness Hardas. (IAWC Ex. 4.00SR at 10.)

7. Unaccounted-For Water Expenses
8. Depreciation/Amortization Adjustment

In his direct testimony, AG witness Effron proposed an adjustment to depreciation expense to match the depreciation expense supported by the Company's depreciation schedules. (AG Ex. 1.0 at 21-22.) IAWC witness Kerckhove indicated that the adjustment removed amortization expense recorded in accounts 406 and 407 and that the amortization expense for these accounts had been included in the Company's last three rate cases and should be included in this case. (IAWC Ex. 4.00R at 18.) In his rebuttal testimony, AG witness Effron withdrew the proposed adjustment. (AG Ex. 3.0 at 3.)

9. Miscellaneous/Other Revenues

Both AG witness Effron and IIWC/FEA/CUB witness Gorman proposed similar adjustments in direct testimony to update the test year miscellaneous revenues to reflect more recent data. (AG Ex. 1.0 at 11-12; AG Ex. 1.1, Sch. C-1; IIWC/FEA/CUB Ex. 1.0 at 8-9; IIWC/FEA/CUB Ex. 1.2.) In rebuttal testimony, Company witness Kerckhove updated the level of miscellaneous revenues to reflect the actual 12-month period ending May 2016 adjusted for rent revenue that the Company was no longer receiving. (IAWC Ex. 4.0R at 16-17.) In his rebuttal testimony, Mr. Gorman proposed a further adjustment to increase miscellaneous revenues for late fees that IAWC was unable to collect from January 1 through May 31, 2016. (IIWC/FEA/CUB Ex. 2.0 at 22. In his surrebuttal testimony, IAWC witness Kerckhove agreed with the additional adjustment and incorporated the adjustment into the surrebuttal revenue requirement schedules. (IAWC Ex. 4.00SR at 7-8; IAWC Ex. 4.02SR (Rev.), col (l).)

10. Current Rate Case Expense
11. Unamortized Docket 09-0319 Rate Case Expense

AG witness Effron and Staff witness Kahle each proposed an adjustment in direct testimony to remove the rate case expense correction from pro forma rate case expense. (AG Ex. 1.0 at 18-20; Staff Ex. 3.0 at 3-6.) The Company claimed that the correction represented unamortized rate case expense from Docket No. 09-0319 that had been inadvertently omitted from the Company's prior rate case, Docket No. 11-0767.

In rebuttal testimony, Company witness Richard Kerckhove argued that the unamortized balance of rate case expense from the prior rate case, Docket No. 09-0319, is recoverable, on a re-amortized basis, in subsequent cases and that the unamortized balance had been inadvertently not included in the rate case expense considered in the company's last rate case, Docket No. 11-0767. He further described the costs as representing a portion of the 2009 rate case costs to be amortized

over a five-year period, a portion of the 2009 rate case costs to be amortized over a three-year period, and a portion of the 2007 rate case costs that were to be amortized over a three and five-year periods. (IAWC Ex. 4.0 at 5-8.)

AG witness Effron argued in his rebuttal testimony that the appropriate case for this cost to be included as rate case expense to be amortized would have been in Docket No. 11-0767. AG witness Effron opined that the Company did not have an option to selectively determine in which rate proceeding prior unamortized rate case costs should be recovered. The Commission entered its order in Docket No. 11-0767, assessed the justness and reasonableness of the Company's rate case expenses, and determined the amount of rate case expense to be included in rates in that case. That order should be deemed a final determination of the reasonableness of the cumulative rate case costs incurred up to that time. (AG Ex. 3.0 at 11-12.)

In surrebuttal testimony, IAWC witness Kerckhove, accepted the adjustment to remove the prior rate case expense. (IAWC Ex. 4.00SR at 7.)

12. Long-Term Performance Plan Expense

Company witness Watkins accepted Staff witness Kahle's adjustment subject to a correction regarding payroll taxes to remove 100% of the cost associated with LTPP in surrebuttal testimony for purposes of narrowing the issues in this docket. (IAWC Ex. 7.00SR (Rev.) at 10-11.)

AG witness Effron (AG Ex. 1.0 at 14-18; AG Ex. 3.0 at 10-11) and IIWC/FEA/CUB witness Gorman (IIWC/FEA/CUB Ex. 1.0 at 12-14; IIWC/FEA/CUB Ex. 2.0 at 28-also recommended disallowing 100% of the LTPP.

C. Recommended Operating Revenues and Expenses

V. Riders

A. Contested Issues

1. Rider VBA

The AG does not oppose the Company's Rider VBA in concept, but made several recommended changes to the tariff. Perhaps the most important change was Mr. Rubin's observation that the rider as originally proposed would inappropriately recover certain variable costs, such as the costs of chemicals, the cost of power to operate pumps, and certain waste disposal costs. Mr. Rubin proposed that these variable costs not be recovered through Rider VBA. (AG Ex. 2.0 at 14.) Staff witness David Brightwell came to the same conclusion in his direct testimony. (Staff Ex. 8.0 at 5-7.)

In rebuttal, the Company stated that it was not opposed to the respective alternatives to IAWC's Rider VBA proposed by Mr. Rubin and Dr. Brightwell. According to IAWC, Mr. Rubin's and Dr. Brightwell's respective proposals remove variable costs from recovery through Rider VBA. Company witness Watkins went on to say that if the Commission does not adopt IAWC's version of the rider, it should adopt a tariff similar to that proposed by Mr. Rubin. (IAWC Ex. 4.00R at 4.) In surrebuttal, Mr. Watkins testified that in the interest of narrowing the issues in this matter, the Company is willing to accept Dr. Brightwell's proposal to recover only volumetric charges through Rider VBA and to also use Dr. Brightwell's suggested tariff formula. (IAWC 7.00SR (Rev.) at 2) Subsequently, in response to a Company discovery request to the AG, the AG agreed to accept Dr. Brightwell's proposal to remove volumetric costs from Rider VBA recovery and his recommended Rider formula. (IAWC-AG Stipulated Cross-Ex. 2.00 at 1)

While the AG agrees with Staff and IAWC on those points, Mr. Rubin recommended two other changes to Rider VBA that the People ask be adopted. The first issue concerns IAWC's proposal that all Zone 1 regions pay the same rate adjustments under Rider VBA. Mr. Rubin explained that the Company's proposal is unfair to the South Beloit and Chicago Metro Lake

regions because the customers in these areas variable costs are not recovered through base rates like the customers in all of the other areas in Zone 1. Instead, South Beloit and Chicago Metro Lake pay their variable costs (consisting of purchased water) through a separate rider and, as a result, pay lower fixed charges than other Zone 1 customers. (AG Ex. 2.0 at 15.) To address this issue, Mr. Rubin calculated the percentage of fixed charges for both the South Beloit and Chicago Metro Lake regions. His calculations and results are shown on AG Ex. 2.6.

In his rebuttal testimony, Mr. Rubin testified that in response to an AG discovery request to IAWC, the Company agreed that it was appropriate to calculate a separate Rider VBA charge for the South Beloit and Chicago Metro Lake regions. (AG Ex. 4.0 at 3; AG Ex. 4.1.) However, in its rebuttal testimony, the AG asserted that IAWC shifted positions and Mr. Watkins asserted that the administrative burdens would be too great, and the rate impacts too small, to justify separate VBA charges for the South Beloit and Chicago Metro Lake areas. (IAWC 7.00R at 9-11.)

In his rebuttal, Mr. Rubin took issue with Mr. Watkin's characterization that the rate impacts are insignificant. Mr. Rubin's calculations showed that IAWC's proposed rate for 100 gallons of water for customers in the portions of Zone 1 that do not purchase water (that is, areas other than South Beloit and Chicago Metro Lake) would change by as much a s2%. (AG Ex. 4.0 at 3-4.) Mr. Rubin's analysis shows that the rate adjustments for the South Beloit and Chicago Metro Lake areas would be 1.9% and 0.3% of base rates in 2013, respectively. (*Id.* at 4; AG Ex. 4.3.) Mr. Rubin concluded that, contrary to Mr. Watkins' assertion, such impacts on base rates are significant and justify separate Rider VBA calculations for the purchased-water areas of Zone 1. (AG Ex. 4.0 at 4-5.)

Mr. Rubin's second point regarding Rider VBA is that wastewater customers should be exempt from the tariff. Mr. Rubin explained that unlike water revenues, approximately 85% of the

Company's wastewater revenues are fixed. Given that due to the very high level of fixed costs means that wastewater customers pay a flat rate that varies very little from month-to-month, there is no reason to apply Rider VBA to wastewater customers. (AG Ex. 2.0 at 15-16.)

In sum, the AG argued that the Commission should modify Rider VBA in two ways: (1) to require IAWC to calculate separate Rider VBA charges for the Beloit and Chicago Metro Lake areas of Zone 1 and (2) to exclude wastewater customers from the tariff.

B. Resolved Issues
2. Pension/OPEB Rider
3. Rider QIP Recommendation

VI. Rate Design and Cost of Service

A. Contested Issues
1. Purchased Power Cost Allocation
2. Simplification of Metered Large User Water Tariff
3. Customer Records, Collection Labor, Uncollectible Accounts

AG witness Rubin testified that IAWC included all "Costs Related to Collecting and Billing" (or $34,686,684) in its proposed customer charge. That amount includes $4,150,323 in collection expenses and $2,587,363 of uncollectible accounts. Those costs total $6,737,686. AG Ex. 2.0 at 8.

Mr. Rubin testified that by including collection expenses and uncollectibles in the customer charge, all customers are responsible for an equal amount of the expenses. Because collection expenses and uncollectibles are a function of bill size, which is primarily a function of usage, Mr. Rubin testified it is unfair to charge all customers the same amount for these costs. Rather, these costs should be apportioned based on customer usage; that is, customers using greater amounts of water are responsible for a larger share of collection expenses and uncollectibles than those

customers using less water. Mr. Rubin recommended that $6,737,686 be removed from "Costs Related to Collecting and Billing." (*Id*. at 8-9.)

In his rebuttal testimony, Mr. Rubin expanded on his proposal. He explained that it is fairer to require all residential customers to pay an equal percentage of their bill to recover collection expenses and unclollectibles than to charge each customer the same amount as proposed by IAWC. Mr. Rubin added that while there is no "right" answer as to how to recover these costs, because there is a relationship between water usage and non-payment, it is fairer that all residential customers pay an equal percentage of their bills, resulting in higher-use customers paying a greater absolute amount of collection expenses and uncollectibles. (AG Ex. 4.0 at 6-7.)

In its Initial Brief, IAWC argued that Mr. Rubin's proposal should be rejected because "there is no difference in the cost to generate and collect a water bill for $40, and the cost to generate and collect a water bill for $80 (or $100, $500, or $1000)." (IAWC Initial Brief at 84-85, *quoting* IAWC Ex. 11.00SR at 3:45-47.) The AG responded that IAWC's argument misses the point. Mr. Rubin took no issue with the cost the Company incurs to issue a bill. Rather, while conceding that there is no "right" answer as to how to recover these costs, Mr. Rubin argues that because there is a relationship between water usage and non-payment, it is fairer that all residential customers pay an equal *percentage* of their bills toward this cost item, resulting in higher-use customers paying a greater absolute amount of collection expenses and uncollectibles. (AG Ex. 4.0 at 6-7.)

For these reasons, the AG argued that the Commission should adopt Mr. Rubin's proposal to remove $6,737,686 from IAWC's "Costs Related to Collecting and Billing."